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Generating Income through the Options Market - The Bull Put Spread

The bull put spread is a strategy that can be used to generate income when an investor has a short or long term neutral to moderately bullish view on a stock or index. The spread defines both the profit the investor receives if the strategy is successful and the maximum loss on the trade. It is commonly referred to as a 'credit put spread'.

In order to execute the bull put spread the investor will generally sell an out-of-the-money put option (meaning below the current share price or index level) and buy a deeper out-of-the-money put option (the protection). Both put options reflect the same underlying stock or index and the same expiration date.

The premium received for selling the out-of-the-money put option will exceed the price paid for the deeper out-of-the-money put option and the investor will receive the difference between the two as a premium or 'income'. The maximum loss on the trade is defined by the difference between the two strike prices of the put options 'the spread' minus the premium received. Margins are payable on the position.

The bull put spread is executed as follows;

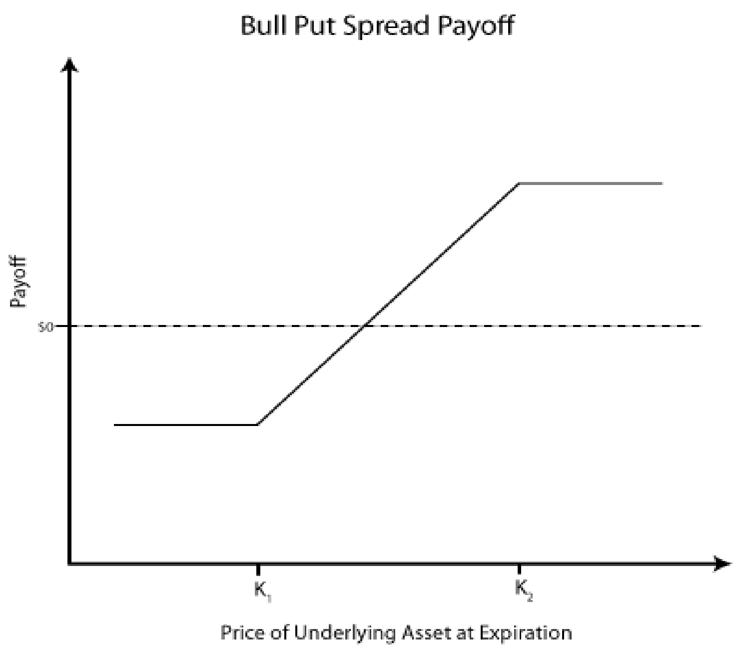
Stock XYZ is currently trading at $47, the investor has a view the stock XYZ will hold its price or rise moderately over the coming month. Additionally the investor is highly confident the stock will not fall below $45.00 .

As such the investor sells 10 contracts of XYZ JAN $45.00 put option ($K_2$) for $0.50 and buys 10 contracts of XYZ JAN $44.50 put option ($K_1$) for $0.40. **Note:** Writing the spread at $45.00 has given the investor a $2 buffer between the current share price and the sold leg of the spread.

The income the investor derives from selling the spread is 10 (10 contracts) x $0.10 ($0.50-$0.40) x 1000 (1,000 shares per contract) **=$1,000** (excluding brokerage), representing a 20% return on the trade if successful.

The maximum loss from the trade is $0.50 ($45.00 -$44.50) x 10 (10 contracts) x 1000(1,000 shares per contract) minus the premium received of $1,000 **= $4,000** (excluding brokerage),

The breakeven point is the strike price of the sold put (in this example $45.00) minus the premium received ($0.10), being a XYZ share price of $44.90.



Four possible Scenarios will occur;

1) The XYZ share price trades sideways for the month of January and at expiry closes above $45.00. Both the $45.00 and the $44.50 XYZ JAN put option expire worthless and the investor retains the premium for the month.
2) The XYZ share price rises moderately closing well above the $45.00 XYZ JAN put option on expiry. As such both the $45.00 and the $44.50 XYZ put option expire worthless and the investor retains the premium for the month.
3) The XYZ share price falls below the $45.00 and $44.50 put option on expiry. Both XYZ put options will be valued intrinsically in relation to the share price and the maximum loss for the spread is realised.
4) The XYZ share price finishes in-between the $45.00 and $44.50 XYZ JAN put option on expiry. Both XYZ put options will be valued intrinsically in relation to the share price (i.e. if the share price is $44.75 the intrinsic value of the $44.50 put option is zero and the intrinsic value of the$45.00 put option will be $0.25), and the investor closes out the trade at the best possible price minimising the loss on the trade.

Alternative action prior to expiry

1) If the investors view on the share price or index changes significantly prior to the option expiry date, the investor can close out the position on the market by buying back the spread. The closing transaction relieves the investor of the exposure on the spread and the margin requirements. Additionally the investor can 'leg out' the position to reflect their view of the underlying share price or index level i.e. close out (buy) the sold leg to profit from a fall in the underlying share price or index level.
2) If the share price or index level rises modestly to a level where the theoretical value of the put options are near worthless, the investor may decide to close out (buy) the sold put option consequently removing the exposure and the margin requirements of the spread.

Other risks to consider

Selling a put option gives you the obligation (if assigned) to buy stock at the strike price of the put option. Once the share price falls near or below the sold put before or on expiry, the investor should determine if they are willing to accept the risk of being assigned and the costs associated with a stock transaction. Bearing in mind the investor has the right but not the obligation to sell the same stock at the strike price of the brought put option (the protection) to limit the loss of the trade.

Overall, The bull put spread or 'credit put spread' is an effective strategy that can be used to generate income on a regular basis from a neutral to moderately bullish view on a share price or index level. A spread constructed of out-of-the-money options produces a 'buffer' between the current share price or index level and the price of the sold put option allowing for volatility in the underlying share price or index. Additionally the ability to 'leg out' once the spread trade has been implemented gives the investor flexibility for a change in view in the underlying.

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For more information on this strategy please call New York Securities Pty Ltd on (08) 9363 1700 to speak to an Accredited Derivatives Advisor.

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